BEFORE THE

SOUTH CAROLINA PUBLIC SERVICE COMMISSION

IN THE MATTER OF:	)	
APPLICATION OF SOUTH CAROLINA	)	
ELECTRIC AND GAS COMPANY FOR AN	)	**DOCKET NO. 2004-178-E**
INCREASE IN ITS ELECTRIC RATES	)	
AND CHARGES	)	

SURREBUTTAL TESTIMONY AND EXHIBIT

OF

GLENN A. WATKINS

ON BEHALF OF THE

SOUTH CAROLINA CONSUMER ADVOCATE

October 29, 2004

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Q. PLEASE STATE YOUR NAME.

A. My name is Glenn A. Watkins.

Q. ARE YOU THE SAME GLENN A. WATKINS THAT PRE-FILED DIRECT TESTIMONY IN THIS CASE?

A. Yes.

Q. PLEASE COMMENT ON DR. MALKIEL'S REBUTTAL TO YOUR PROPOSAL TO INCLUDE SHORT-TERM DEBT IN SCE&G'S CAPITAL STRUCTURE FOR RATEMAKING PURPOSES.

A. Dr. Malkiel concludes there are two reasons for not considering short-term debt in the ratemaking process. First, he claims that short-term debt is used to finance the portion of CWIP that is not included in rate base. The assertion that short-term debt is earmarked to specifically fund costs incurred outside the regulatory process is not consistent with the Company's earlier positions. In the 2002 case, SCE&G claimed that a primary reason for the new equity issue was the need to raise capital to help fund its large construction program – namely the Jasper and Saluda Dam projects. The fact remains that SCE&G employs a substantial level of short-term debt to provide cash and capital to the Company. Short-term debt does not appear to be used exclusively for CWIP.

It has come to my attention through Mr. Marsh's rebuttal testimony that the Company alleges that AFUDC accrues at the short-term debt interest rate. As I stated above, this was not the Company's explanation in the 2002 case, nor was it cited as justification in the 2002 Commission Order. I have also not seen anything in this case that demonstrates that treatment. If this is, in fact, the way this item is treated, short-term debt would be considered in the ratemaking process, and I would withdraw my recommendation concerning short-term debt in the Company's capital structure.

The second point that Dr. Malkiel is wrong about is his claim that short-term debt is usually more expensive than long-term debt. My Schedule 1 (SR) provides a comparison of short-term and long-term interest rates annually from 1974 through the present. As shown on this schedule, short-term interest rates were in double digits during the four-year period 1979 through 1982, and as we all remember, inflation was out of control in a stagnant economy such that short-term interest rates were, in fact, higher than long-term rates during three of those years. I certainly would not consider the economic times of 1979 through 1981 to be normal, however. Finally, whether short-term debt interest rates are higher or lower is really immaterial, since these funds represent a source of funding to the utility and the actual costs should be reflected in establishing rates.

Q. DR. MALKIEL STATES THAT HIS RELIANCE ON A SINGLE SOURCE FOR GROWTH ESTIMATES IS SUPERIOR TO YOUR CONSIDERATION OF SEVERAL ESTIMATES. PLEASE COMMENT.

A. With respect to relying only on the First Call/IBES stock analyst projections of earnings growth, consider the following occurrences.

First, recent academic scholarship has challenged the accuracy of analysts' Earnings Per Share (EPS) forecasts. A prominent example is a November/December 1998 article in the <u>Financial Analysts Journal</u> entitled "Why So Much Error in Analysts' Earnings Forecasts?", by Vijay Kumar Chopra. In this article, the author concluded, "Analysts' forecasts of EPS and growth in EPS tend to be overly optimistic." He also concluded that analyst forecasts of EPS over the past 13 years have been more than twice the actual growth rate.

A second source is less academic and more directly tied to the financial mainstream. On March 26, 2002, Federal Reserve Chairman Alan Greenspan spoke to an audience at the Stern School of Business of New York University. In that speech, (available at the FRB's website: http://www.federalreserve.gov), the Chairman addressed the historical relationships and roles of corporations, financial institutions and brokerage-based investment analysts:

> "For the most part, despite providing limited incentives for board members to safeguard shareholder interest, this paradigm has worked well. We are fortunate for financial markets have had no realistic alternative other than to depend on the chief executive officer to ensure an objective evaluation of the prospects of the corporation. Apart from a relatively few large institutional investors, not many existing or potential shareholders have the research capability to analyze corporate reports and thus judge the investment value of a corporation. This vitally important service has become dominated by firms in the business of underwriting or selling securities."

> "But, as we can see from recent history, long-term earnings forecasts of brokerage-based securities analysts, on average, had been persistently overly optimistic. Three-to five-years earnings forecasts for each of the S&P 500 corporations, compiled from projections of securities analysts by I/B/E/S, averaged almost 12 percent per year between 1985 and 2001. Actual earnings growth over the period averaged about 7 percent."

> "Perhaps the last sixteen years for which systematic data have been available are an historic aberration. But the persistence of the bias year after year suggests that it more likely results, at least in part, from the proclivity of firms that sell securities to retain and promote analysts with an optimistic inclination. Moreover, the bias apparently has been especially large when the brokerage firm issuing the forecast also serves as an underwriter for the company's securities."

> "The performance of securities analysts may improve as a result of the recent joint initiative by the National Associates of Securities Dealers and the New York Stock Exchange to require brokerage firms to include in research reports the distribution of the firms' ratings among "buy," "sell," and "hold" for example. Brokerage firms must also include in research reports a record that indicates when an analyst assigned of changes a rating for a company."

> "I suspect that with the underlying database publicly available, it is just a matter of time before the ex post results of analysts' recommendations are compiled and published on a regular basis. I venture to say that with such transparency, the current upward bias of analysts' earnings projections would diminish rather rapidly, because investment firms are well aware that security analysis without credibility has no market value." [Emphasis added]

During 2003, ten of the nation's largest securities firms agreed to pay a record $1.4 billion in penalties to settle U.S. government charges involving investor abuses, many of which resulted from analysts' forecasts and recommendations that the government charged were biased and subject to conflicts of interest. This settlement largely grew out of a New York State investigation and reflects the national, and even international, scope of the negative perceptions of analysts' forecasts and recommendations. These, and other similar investigations and complaints have underscored a growing awareness that analysts' estimates cannot be considered an unbiased source of growth expectations by investors, and this has important implications for a DCF analysis that incorporates any such estimates.

Arguably, it could be maintained that these events may have created an impetus for a reduction in the perceived abuses that some analysts have been accused of, and perhaps even an improvement in the accuracy of analysts' forecasts. However, from many investors' perceptions, the damage to analysts' credibility and objectivity will likely linger on for a long time. The negative perceptions regarding analysts - as evidenced by fines, consent decrees, and the reporting on these events in the popular and business press - indicate that many investors will be loath to place primary reliance, and certainly not exclusive reliance, on analysts' forecasts in making their investment decisions.

I fully explained why it is more appropriate to consider more than one growth estimate in evaluating a firm's cost of equity in my direct testimony. In addition, I also conducted an alternative cost of equity analysis using only forecasted earnings growth which produced a similar, albeit somewhat lower, result than my recommendation.

Q. PLEASE COMMENT ON DR. MALKIEL'S REBUTTAL TO YOUR CAPM ANALYSIS.

A. In his direct testimony, Dr. Malkiel asserted that SCE&G is more risky due to his claim that the Company is of small size. His assertion is that SCANA is more closely aligned to the Ibbotson small stock group than to the S&P 500. I explained in my direct testimony why this is not correct. Now, in rebuttal, Dr. Malkiel claims that SCANA is a "mid-cap" stock, and that the appropriate risk premium should somehow be at least two percentage points higher.

Perhaps Dr. Malkiel's disdain for the CAPM has caused him to ignore the theory and mechanics behind this well accepted financial model. It is the stock's beta that captures and measures a stock's diversifiable risk, not the market risk premium. As I explained in my direct testimony, beta measures the relative risk of a company vis-a-vis the market risk. This risk, measured by beta, reflects firm size, type of business or industry, and all other diversifiable elements of risk surrounding a particular stock. It is totally at odds with the CAPM to adjust the market risk premium to reflect an individual company's risk. Rather, that Company's risk profile is embedded in its beta.

Q. DO YOU HAVE ANY COMMENTS REGARDING DR. MALKIEL'S REBUTTAL ON THE SUBJECT OF FLOTATION COSTS?

A. No, my direct testimony explains in detail why it is inappropriate to consider any flotation costs in this proceeding.

Q. PLEASE COMMENT ON DR. MALKIEL'S ASSURANCE TO THE COMMISSION THAT TELEPHONE COMPANIES WITH SIGNIFICANT WIRELESS ACTIVITIES ARE CONSIDERED LESS RISKY PRIMARILY BECAUSE OF THE DIVERSIFICATION FROM WIRE LINE DEPENDENCE AND THE GREATER GROWTH ASSOCIATED WITH WIRELESS.

A. This statement simply does not agree with the facts. To test Dr. Malkiel's claim consider the following table:

	Value Line Risk Measures			
	Safety		Beta	
	1994	2004	1994	2004
Bell Atlantic	2		0.90	
Verizon		2		1.00
NYNEX	1		0.80	
Bell South	1	2	0.80	1.00
SW Bell	1		0.90	
SBC		2		1.05

As is clearly exhibited above, these telecommunication companies have become more risky as they have ventured ("diversified") into highly competitive technologies. Higher Safety and Beta numbers denote an increase in the riskiness of these companies.

Q. PLEASE COMMENT ON DR. MALKIEL'S DISCUSSION ON THE STATUS OF CURRENT INTEREST RATES.

A. In his direct testimony, Dr. Malkiel cited two reasons why this Commission should consider an allowed rate of return on equity substantially higher than the analyses he conducted or those of any other expert in this case. One of his two reasons involves the current state of low capital costs. I explained and provided irrefutable data showing that Dr. Malkiel's statement was wrong in my direct testimony. There is no doubt that consumers, governments, and businesses are all enjoying low capital costs. Will these costs rise or fall in the near future? I do not know. What I do know is that capital costs are forward looking and the financial community, as a whole, anticipates a continuation of low capital costs. Dr. Malkiel's opinion as to the near term future of interest rates is completely speculative, and should be given no weight in this case.

Q. DO YOU HAVE ANY COMMENTS TO DR. MALKIEL'S REBUTTAL CONCERNING HIS SINGLE POINT (SINGLE DAY) DCF ANALYSIS?

A. Yes. Apparently, Dr. Malkiel concedes that his DCF analysis is inappropriate and that consideration to earlier periods should be given as well. I remind the Commission that my DCF analysis encompasses a three month period from June through August of this year, as presumably now advocated by Dr. Malkiel. Finally, Dr. Malkiel prepared his rebuttal testimony in late October 2004 and considers stock prices in May and July. He does not mention DCF rates calculated on prices subsequent to July.

Q. PLEASE DISCUSS MS. WALKER'S REBUTTAL TO YOUR NCEMC CONTRACT ADJUSTMENT (ADJUSTMENT #1)

A. Ms. Walker claims that the most recent data regarding the NCEMC energy margins suggest that my revenue annualization amount is overstated. However, Ms. Walker did not provide this new data in her rebuttal testimony. Because these two contracts are both new to SCE&G, historical patterns are not available. Knowledge of the specific contract language might be helpful in evaluating the energy margins that will be realized during the remainder of 2004. However, I do not object to annualizing this revenue based on the most current information available. In this regard, I would invite Ms. Walker to update my annualization using the methodology I propose in my direct testimony.

Q. WHAT COMMENTS DO YOU HAVE REGARDING MS. WALKER'S REBUTTAL TO YOUR PROPOSED FIVE YEAR AMORTIZATION PERIOD?

A. Ms. Walker reasons that a three year amortization period is more appropriate because it more closely mirrors the period in which ratepayers were overcharged in the first place. To me, her logic is that two wrongs make a right. To be sure, it must remembered that the dollar amount in question represents the Consumer Advocate's agreement to allow re-collection of revenue that was collected from ratepayers in a manner inconsistent with the laws of South Carolina at the time. The Consumer Advocate believed the most equitable solution was to allow SCE&G recovery of costs incurred over a reasonable period of time. In my opinion, and for the reasons set forth in my direct testimony, a five-year amortization period strikes a more equitable balance for ratepayers and the Company.

Q. DO YOU HAVE ANY COMMENTS REGARDING MS. WALKER'S REBUTTAL TO YOUR HEALTHCARE ADJUSTMENT?

A. Ms. Walker claims that more recent data suggests that her initial annualization is appropriate, yet she does not provide the data. However, the most important thing to remember is that South Carolina operates under a historical test year concept. Absent any known changes (such as using current insurance rates that are actually known), an opinion could easily be reached that SCE&G is only entitled to actual test year costs. I have recognized that healthcare costs are rising faster than inflation generally, and allowed an increase to test year healthcare expenses. My healthcare adjustment is reasonable and should be adopted by the Commission.

Q. WHAT COMMENTS DO YOU HAVE REGARDING MS. WALKER'S REBUTTAL TO YOUR RECOMMENDATION TO REVERSE THE COMPANY'S PROPOSAL TO COLLECT NOW, FOR FUTURE TRANSMISSION COSTS (ADJUSTMENT #13C)?

A. My direct testimony speaks for itself. SCE&G is proposing to collect now for estimated costs that it will likely incur in the future. Future costs based on estimates should not be reflected in the current prices paid by SCE&G's captive customers.

Q. DO YOU HAVE ANY COMMENT REGARDING MS. WALKER'S REBUTTAL TESTIMONY REGARDING FOSSIL FUEL INVENTORIES?

A. No. My direct testimony clearly explains why the Company's proposal should be rejected.

Q. WHAT COMMENTS DO YOU HAVE REGARDING CASH WORKING CAPITAL?

A. In addition to my explanation of the benefits of lead lag studies over the formula approach contained in my direct testimony, I reiterate that the FERC and every state in the nation, except South Carolina and one other state requires lead lag studies. Lead lag studies seem to be the consensus approach of regulatory authorities throughout the country.

Q. PLEASE COMMENT ON MS. WALKER'S ASSERTION THAT YOU HAVE NOT CONSIDERED ALL BOOKED INTEREST EXPENSES IN YOUR INTEREST SYNCHRONIZATION ADJUSTMENT.

A. I received the Company's rebuttal testimony in a timely manner late yesterday afternoon (Wednesday 10/26/04). Due to other commitments, and the short time period I have to prepare this surrebuttal testimony, I have not been able to investigate Ms. Walker's claim. However, if SCE&G's books reflect interest that is not called "interest" associated with long-term or short-term debt, and is otherwise reflected in the Company's cost of service, I concur that this amount should be considered in determining income tax expense. I also agree that the appropriate income tax rates should be used. I do not believe I have erred in this regard, but if I did, the appropriate income tax rates should be used.

Q. PLEASE COMMENT ON MS. WALKER'S REBUTTAL TESTIMONY THAT ALL BONUS PAY SHOULD BE INCLUDED IN THE COMPANY'S COST OF SERVICE.

A. I fully explained why this is not appropriate in my direct testimony. Instead of disallowing all bonus pay, I propose an equitable 50/50 sharing of these profit-based bonuses.

Q. PLEASE COMMENT ON MR. MARSH'S REBUTTAL TESTIMONY REGARDING THE COMPANY'S PROPOSED COLLECTION OF FUTURE TURBINE COSTS.

A. The major thrust of Mr. Marsh's discussion appears to be an argument that these forecasted future expenditures will be expensed instead of capitalized. The cost of refurbishments and major overhauls are capitalized, not expensed, as discussed by Company Witness Addison on page 8 of his direct testimony.

Nevertheless, whether these estimated future costs will be expensed or capitalized is irrelevant regarding the Company's proposed ratemaking treatment of these estimated future costs. The fact remains that the Company is seeking recovery today of unknown costs that will be incurred several years in the future. The Company's proposal should be rejected in its entirety.

Q. DO YOU HAVE ANY COMMENTS TO THE REBUTTAL TESTIMONY OF DR. WRIGHT?

A. Yes. The history of RTOs and the failed GridSouth project were fully litigated in SCE&G's last rate case. The Commission denied any recovery of GridSouth costs in that case and nothing has changed since that time to alter or reverse the Commission's decision in that case. The Company's proposal to once again seek recovery should be rejected in this case as well.

Q. DOES THIS COMPLETE YOUR SURREBUTTAL TESTIMONY?

A. Yes.

INTEREST RATES

YEAR	US TREAS T BILLS 3 MONTH	US TREAS T BONDS 10 YEAR
1975	5.84%	7.99%
1976	4.99%	7.61%
1977	5.27%	7.42%
1978	7.22%	8.41%
1979	10.04%	9.44%
1980	11.51%	11.46%
1981	14.03%	13.93%
1982	10.69%	13.00%
1983	8.63%	11.10%
1984	9.58%	12.44%
1985	7.48%	10.62%
1986	5.98%	7.68%
1987	5.82%	8.39%
1988	6.69%	8.85%
1989	8.12%	8.49%
1990	7.51%	8.55%
1991	5.42%	7.86%
1992	3.45%	7.01%
1993	3.02%	5.87%
1994	4.29%	7.09%
1995	5.51%	6.57%
1996	5.02%	6.44%
1997	5.07%	6.35%
1998	4.81%	5.26%
1999	4.66%	5.65%
2000	5.85%	6.03%
2001	3.45%	5.02%
2002	1.62%	4.61%
2003	1.02%	4.01%
2004		
Jan	0.89%	4.15%
Feb	0.92%	4.08%
Mar	0.94%	3.83%
Apr	0.94%	4.35%
May	1.04%	4.72%
June	1.27%	4.73%
July	1.35%	4.50%
Aug	1.48%	4.28%
Sept		

Sources: Council of Economic Advisors, Economic Indicators; Moody's Bond Record; Federal Reserve Bulletin; various issues.